An Explanation of Clean Renewable Energy Bonds

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In July, 2005, Congress passed the Energy Tax Incentives Act of 2005 (the "Act"). Among a number of other tax incentives, the Act permits State and local governments, cooperative electric companies, clean renewable energy bond lenders and Indian tribal governments to issue "clean renewable energy bonds" ("CREBs") to finance certain renewable energy and clean coal facilities. Part I of this article addresses the mechanics of issuing CREBs, including those projects that may be financed through the issuance of CREBs. Part II of this article discusses how the tax benefits of CREBs flow to investors.

CREBs are a new form of tax credit bond in which interest on the bonds is paid in the form of federal tax credits by the United States government in lieu of interest paid by the issuer. CREBs, therefore, provide qualified issuers/qualified borrowers with the ability to borrow at a 0% interest rate. The federal tax benefit to the holder of a CREB is greater than the benefit derived from tax-exempt municipal bonds in that the tax credit derived from a CREB can be used to offset, on a dollar-for-dollar basis, a holder's current-year tax liability, as opposed to excluding interest from gross income, as permitted for tax-exempt bonds. Unlike tax-exempt bonds, CREBs are taxable obligations, and the tax credits received are treated as interest and included in a bondholder's taxable income.[1]

I. The Mechanics of CREBs.

Added by the Act, Section 54 of the Internal Revenue Code of 1986 (the "Code")[2] provides that the term "clean renewable energy bond" means any bond issued as part of an issue if (1) the bond is issued by a qualified issuer, (2) the bond is issued pursuant to an allocation by the Secretary of the Treasury to such issuer of a portion of the national clean renewable energy bond volume authority, (3) 95% or more of the proceeds of the issue are to be used for capital expenditures incurred by qualified borrowers for one or more qualified projects, (4) the qualified issuer designates such bond for purposes of Section 54 and the bond is issued in registered form, and (5) the qualified issuer meets the applicable spending requirements. The foregoing requirements are discussed below.

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[1] With a few notable distinctions, CREBs share many of the same tax characteristics as qualified zone academy bonds ("QZABs"), which permit qualified schools and education agencies to borrow at a 0% interest rate, with holders of the QZABs receiving federal tax credits in lieu of interest.

[2] Unless otherwise indicated, all section references herein shall be to the Internal Revenue Code of 1986.

A. Qualified Issuers.

A "qualified issuer" is defined as a clean renewable energy bond lender, a cooperative electric company or a governmental body.[3] A "clean renewable energy bond lender" means a cooperative that is owned by, or has outstanding loans to, 100 or more cooperative electric companies and was in existence on February 1, 2002, and shall include any affiliated entity controlled by such lender.[4] This includes CoBank, ACB and the National Rural Utilities Cooperative Finance Corporation.

"Cooperative electric company" means a mutual or cooperative electric company described in Section 501(c)(12) or Section 1381(a)(2)(C), or a not-for-profit electric utility which has received a loan or a loan guarantee under the Rural Electrification Act.[5]

A "governmental body" includes any State, territory, possession of the United States, the District of Columbia, Indian tribal government and any political subdivision thereof.[6]

B. Allocation of National CREB Volume Authority.

In order to issue CREBs, qualified issuers must obtain an allocation of bond volume authority from the Secretary of the Treasury. The Act provides for a national maximum volume cap of $800,000,000, with the amount allocable to governmental bodies not permitted to exceed $500,000,000.[7]

To obtain an allocation of bond volume authority, a qualified issuer is required to submit an application to the Internal Revenue Service ("IRS") no later than April 26, 2006.[8] Each application must: (1) identify the qualified borrower expected to own the project,[9] (2) if any of the bonds are expected to be issued as pooled financing bonds,[10] demonstrate that the qualified issuer will enter into a written loan commitment with each qualified borrower prior to the issue date of the bond issue, (3) describe in detail the project to be financed with the proceeds of the bonds, including the location of the project, the dollar amount of volume authority requested for the project, the plan to obtain all necessary federal, state and local regulatory approvals, and the expected placed in service date of the project, (4) demonstrate that the project will constitute a qualified project[11], and contain a certification by an independent, licensed engineer that the project will be both a qualified project and technically viable, and (5) contain a detailed description of the plan of financing.[12]

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[3] I.R.C. § 54(j)(4).
[4] I.R.C. § 54(j)(2).
[5] I.R.C. § 54(j)(1).
[6] I.R.C. § 54(j)(3).
[7] I.R.C. § 54(f).
[8] I.R.S. Notice 2005-98. Notice 2005-98 provides detailed guidance regarding CREB volume authority allocations and the specifics for volume authority applications.
[9] See Part I, Section C herein for the definition of a "qualified borrower."
[10] "Pooled financing bond" has the same meaning as set forth in Section 149(f)(4)(A), and generally means any bond issued as part of an issue more than $5,000,000 of the proceeds of which are reasonably expected at the time of issuance of the bonds to be used (or are intentionally used) directly or indirectly to make or finance loans to two or more ultimate borrowers.
[11] See Part I, Section C herein for the definition of a "qualified project."
[12] In accordance with I.R.S. Notice 2005-98, an application for volume authority must contain a detailed description of the plan of financing for the project, including all private and public sources of financing and the status of the applicants' efforts to secure all such financing. The application must also describe the anticipated date of bond issuance, the sources of security and repayment for the bonds, the aggregate face amount of bonds expected to be issued for the project, and the issuer's reasonably expected schedule for spending the CREBs proceeds.

The CREB program is somewhat unique in that volume authority will be allocated on a project-by-project basis by IRS staff, as opposed to the historic approach for tax-exempt bonds of allocating volume cap authority to each of the States.[13] It is believed that the requirement that an issuer or borrower obtain a certification of an independent licensed engineer stating that the project is a qualified project and certifying as to the project's technical viability will serve as a safeguard with respect to the IRS project review and approval process.

Qualified projects will be allocated volume authority on a non-discriminatory basis based on the full amount of bond volume authority requested.[14] Volume authority will be allocated beginning with the project(s) for which the smallest dollar amount of volume authority has been requested, and continuing with the project(s) for which the next smallest dollar amount of such limitation has been requested until the total amount of volume authority has been allocated.[15] For example, if the smallest dollar amount of volume authority requested is $10 million for each of 10 different projects, those projects will be granted the full amount of the requested allocation in the total amount of $100 million, and the remaining volume authority will be allocated to the next smallest dollar amount projects (and so forth) until the volume authority is exhausted. For purposes of the allocation rules, all qualified projects located at the same site and owned by the same qualified borrower are treated as a single project.[16]

There are several uncertainties regarding the allocation process. Given that full funding will be provided to project requests beginning with the smallest dollar amount, sponsors of more expensive projects may need to situate themselves within the allocation regime in order to obtain at least a partial allocation. For example, if the total cost of a project is $200 million, it is probable that a request for $200 million of volume authority will not be granted due to the expected volume of smaller dollar requests. Accordingly, the sponsor of such a project will need to consider seeking a smaller allocation (perhaps $10 million to $20 million), in order to obtain partial CREB funding for the project.

C. Qualified Borrowers and Qualified Projects.

In addition to the requirement that CREBs be issued by a "qualified issuer," a CREB-financed project must be owned by a qualified borrower. A "qualified borrower" includes any mutual or cooperative electric company described in Section 501(c)(12) or 1381(a)(2)(C) and any State, territory, possession of the United States, the District of Columbia, Indian tribal government and any political subdivision thereof.[17]

"Qualified projects" include any "qualified facility," as that term is defined in Section 45(d) (other than Indian coal facilities) without regard to any required placed in service date,[18] and specifically include:

1. Wind Facilities. A "wind facility" is defined to mean any facility using wind to produce electricity.[19] The IRS's published position is that a "wind facility" includes the wind turbine (including the blades, gear box, generator and a control and communication mechanism), together with the tower on which the wind turbine is mounted and the pad on which the tower is situated.[20]

[13] See generally, I.R.C. § 146.
[14] I.R.S. Notice 2005-98.
[15] Id.
[16] Id.
[17] I.R.C. § 54(j)(5).
[18] I.R.C. § 54(d)(2). The facilities that may be financed with CREBs are the same renewable projects eligible for the production tax credit under Section 45. Unlike the production tax credit, the various placed in service date rules described in 45(d) are not applicable to projects financed with CREBs.
[19] I.R.C. § 45(d)(1).
[20] Rev. Rul. 94-31, 1994-1 C.B. 16.

Excluded from the definition are transformers, on-site power collection systems, site improvements, and monitoring and meteorological equipment.

2. Closed-Loop Biomass Facilities. A "closed-loop biomass facility" is any facility using organic material from a plant that was planted exclusively for the purpose of being used at a qualifying facility to produce electricity.[21] In addition, a facility qualifies if modified to use closed-loop biomass to co-fire with coal, with other biomass, or with both coal and other biomass, but only if the modification is approved under the Biomass Power for Rural Development Program or is part of a pilot project of the Commodity Credit Corporation.[22]

3. Open-Loop Biomass Facilities. An "open-loop biomass facility" is a facility using open-loop biomass to produce electricity.[23] Open-loop biomass is defined as any agricultural livestock waste nutrients, or any solid, non-hazardous, cellulosic or lignin waste material segregated from other waste materials and which is derived from certain forest-related resources, solid wood waste materials, or agricultural sources.[24] Agricultural livestock waste nutrients are defined as agricultural livestock manure and litter, including wood shavings, straw, rice hulls and other bedding material for the disposition of manure.[25] Eligible forest-related resources are mill and harvesting residues (other than spent chemicals from pulp manufacturing), precommercial thinnings, slash and brush.[26] Solid wood waste materials include waste pallets, crates, dunnage, manufacturing and construction wood wastes (other than pressure-treated, chemically-treated or painted wood waste) and landscape or right-of-way tree trimmings.[27] Agricultural sources include orchard tree crops, vineyard, grain, legumes, sugar and other crop by-products or residues.[28] Qualifying open-loop biomass does not include municipal solid waste, gas derived from biodegradation of solid waste, paper that is commonly recycled, closed-loop biomass or biomass burned in conjunction with fossil fuel (co-firing) beyond such fossil fuel required for start up and flame stabilization.[29]

4. Geothermal or Solar Energy Facilities. A "geothermal facility" is a facility that uses geothermal energy to produce electricity.[30] Geothermal energy is derived from a geothermal reservoir consisting of natural heat stored in rocks or in an aqueous liquid or vapor (whether or not under pressure).[31]

A "solar facility" is a facility that uses solar energy to produce electricity. [32]

5. Small Irrigation Power Facilities. A "small irrigation power facility" is a facility that generates electric power through an irrigation system canal or ditch without a dam or impoundment of water.[33] The nameplate capacity must be equal to or greater than 150 kilowatts, but less than 5 megawatts.[34]

[21] I.R.C. § 45(d)(2)(A).
[22] I.R.C. § 45(d)(2)(A)(ii).
[23] I.R.C. § 45(d)(3).
[24] I.R.C. § 45(c)(3)(A).
[25] I.R.C. § 45(c)(3)(B).
[26] I.R.C. § 45(c)(3)(A)(ii)(I).
[27] I.R.C. § 45(c)(3)(A)(ii)(II).
[28] I.R.C. § 45(c)(3)(A)(ii)(III).
[29] I.R.C. § 45(c)(3)(A).
[30] I.R.C. § 45(d)(4).
[31] I.R.C. § 613(e)(2).
[32] I.R.C. § 45(d)(4).
[33] I.R.C. § 45(c)(5)(A).
[34] I.R.C. § 45(c)(5)(B).

6. Landfill Gas Facilities. A "landfill gas facility" is a facility that uses landfill gas to produce electricity.[35] Landfill gas is methane gas derived from the biodegradation of municipal solid waste.[36]

7. Trash Combustion Facilities. A "trash combustion facility" is a facility that burns municipal solid waste to produce steam to drive a turbine for the production of electricity.[37]

8. Refined Coal Production Facilities. A "refined coal production facility" is a facility that produces refined coal.[38] Refined coal is a qualifying liquid, gaseous or solid synthetic fuel produced from coal (including lignite) or high-carbon fly ash, including such fuel used as a feedstock.[39] The refined coal must be sold by the qualified borrower with the reasonable expectation that it will be used for the purpose of producing steam.[40] In order to be a qualifying fuel, the qualified borrower must certify that when used in the production of steam, the fuel emits at least 20% less nitrogen oxides and either sulfur dioxide or mercury than the burning of feedstock coal predominantly available in the marketplace as of January 1, 2003, and is produced in such a manner so as to result in an increase of at least 50% in the market value of the refined coal (excluding any increase caused by materials combined or added during the production process) than the prices of the feedstock coal.[41]

9. Qualifying Hydropower Facilities. Qualifying hydropower facilities include facilities that produced hydroelectric power (a hydroelectric dam) prior to August 8, 2005, and that subsequently produce incremental hydropower production, but only to the extent that such incremental hydropower production is attributable to efficiency improvements or additions to capacity added after August 8, 2005. "Incremental hydropower production" is the percentage of average annual hydropower production at the facility attributable to the efficiency improvements or additions to capacity added after August 8, 2005, determined using the same water flow information used to determine an historic average annual hydropower production baseline for such facility (ignoring operational changes not directly related to efficiency improvements or additions to capacity). Such percentage and baseline shall be certified by the Federal Energy Regulatory Commission ("FERC").[42]

Qualifying hydropower facilities also include existing facilities that did not produce hydroelectric power on August 8, 2005 that are licensed by the FERC and meet all other applicable regulatory requirements in which turbines or other generating devices are added to the facility after such date to produce hydroelectric power, but only if there is no enlargement of the diversion structure, or construction or enlargement of a bypass channel or the impoundment or any withholding of additional water from the natural stream channel.

The qualifying hydropower facility provisions regarding "incremental hydropower production" may raise a number of interpretational issues for CREB financings. It would appear that the notion of incremental hydropower production is a convention better suited for the application of the

[35] I.R.C. § 45(d)(6).
[36] Id. "Solid waste" is defined for these purposes to mean any garbage, refuse, sludge from a waste treatment plant, water supply treatment plant, or air pollution control facility and other discarded material, including solid, liquid, semisolid, or contained gaseous material resulting from industrial, commercial, mining, and agricultural operations, and from community activities, but does not include solid or dissolved material in domestic sewage, or solid or dissolved materials in irrigation return flows or industrial discharges which are point sources subject to permits under section 1342 of title 33, or source, special nuclear, or byproduct material as defined by the Atomic Energy Act of 1954, as amended. 42 U.S.C. 6903(27).
[37] I.R.C. § 45(d)(7). According to the House Conference Report for the American Jobs Creation Act of 2004 (Pub. L. No. 108-357 (2004)), the burning of the municipal solid waste must be used to produce steam that will drive a turbine that produces electricity. H.R. Conf. Rep. 108-375.
[38] I.R.C. § 45(d)(8). Unlike the other facilities eligible for CREB financing, there is no requirement that the refined coal production facility produce electricity.
[39] I.R.C. § 45(c)(7)(A)(i).
[40] I.R.C. § 45(c)(7)(A)(ii).
[41] I.R.C. § 45(c)(7)(A)(iii) and (iv); I.R.C. § 45(c)(7)(B).
[42] I.R.C. § 45(d)(8).

production tax credit (the "PTC") under Section 45 than CREB financing. Under the rules applicable to the PTC, it seems clear that a taxpayer will derive a PTC for any hydropower production over the historic average annual production baseline for such facility. With respect to financing efficiency improvements or additions to capacity with CREBs, it is not completely clear how such financing should be applied. One reasonable approach, perhaps, would be to apply CREB financing to capital assets which will cause a permanent increase in hydropower production based on the same baseline methodology applied to measure such increase with respect to the PTC.

D. Spending Requirements.

The Act instituted several spending requirements for CREBs. In particular, a qualified issuer of CREBs must reasonably expect: (1) that at least 95% of the proceeds of the issue will be spent for one or more qualified projects within the five-year period beginning on the date of issuance, (2) to enter into a binding commitment within 6 months of the date of issue with a third party to spend at least 10% of the proceeds of the issue, or, in the case of an issue the proceeds of which are to be loaned to two or more qualified borrowers, such binding commitment will be incurred within the six-month period beginning on the date of the loan of such proceeds to a qualified borrower, and (3) the projects will be completed with due diligence and the proceeds of the issue will be spent with due diligence.[43] Upon submission of a request prior to the expiration of the five-year period described in (1) above, the Secretary of the Treasury may extend such period if the qualified issuer establishes that the failure to satisfy the five-year requirement is due to reasonable cause and the related projects will continue to proceed with due diligence.[44] If less than 95% of the proceeds of the issue are spent by the end of the five-year period (or by the end of the extension described in the previous sentence), the qualified issuer shall redeem all of the nonqualified bonds within 90 days after the end of such period.[45] The amount of nonqualified bonds is to be determined under the remedial action rules set forth in Section 142.[46]

E. Refinancing of Prior Debt and Reimbursement.

A taxable line of credit or tax-exempt debt originally incurred to finance a qualified project may be refinanced with the proceeds of CREBs only if the debt being refinanced (including any debt directly or indirectly refinanced by such debt) was originally incurred by a qualified borrower after August 8, 2005.[47]

Proceeds of a CREB may also be used to reimburse a qualified borrower for amounts paid after August 8, 2005 for a qualified project if: (1) prior to the payment of the original expenditure, the qualified borrower declared its intent to reimburse such expenditure with the proceeds of a CREB, (2) not later than 60 days after payment of the original expenditure, the qualified issuer adopts an official intent to reimburse the original expenditure with such proceeds, and (3) the qualified borrower reimburses itself with the proceeds of CREBs not later than 18 months after the date the original expenditure is paid.[48]

The above reimbursement rules are more restrictive than those generally applicable to tax-exempt bonds. Under the reimbursement rules for tax-exempt bonds, the issuer or, if applicable, the conduit borrower must adopt an official intent resolution to reimburse not later than 60 days after the

[43] I.R.C. § 54(h)(1).
[44] I.R.C. § 54(h)(2).
[45] I.R.C. § 54(h)(3).
[46] Id.
[47] I.R.C. § 54(d)(2)(B).
[48] I.R.C. § 54(d)(2)(C).

original expenditure was incurred.[49] In contrast, the CREB reimbursement rules require that the qualified borrower adopt an official intent resolution prior to the payment of any expenses for which reimbursement will be sought. Also, with respect to tax-exempt bonds, the reimbursement from bond proceeds generally must be made no later than 18 months after the original expenditure was paid or the date the project was placed in service or abandoned, compared to a static 18-month rule for CREBs.[50] Given that CREBs introduce a new reimbursement regime, it is easy to see how an unwary borrower might run afoul of the CREB reimbursement rules.

F. Maturity Limitations and Amortization.

The maximum term for an issue of CREBs is the term that the Secretary of the Treasury estimates will result in the present value of the obligation to repay the principal on the bond being equal to 50% of the face amount of such bond.[51] A discount rate equal to 110% of the long-term adjusted applicable federal rate, compounded semi-annually, for the month in which the bond is sold shall be used for this purpose.[52] A bond is "sold" on the first day on which there is a binding contract in writing for the sale or exchange of the bond.[53] The maximum term for a CREB is to be published daily by the Bureau of Public Debt on its Internet site for State and Local Government Series securities at http://www.publicdebt.treas.gov.[54]

For example, assume that an issuer issues $20,000,000 of CREBs on January 1, 2007 to finance a qualified wind facility. Further assume that the long-term adjusted applicable federal rate for the month that the CREBs issue was sold was 5%. The maximum term of the issue would be the number of years that $10,000,000 (50% multiplied by $20,000,000) present valued at 5.50% (110% of 5%), compounded semi-annually, will take to equal $20,000,000. As set forth in the below chart, the maximum term for the CREBs issue would be 12.775 years. [55]

[49] Treas. Reg. § 1.150-2(d)(1).
[50] Treas. Reg. § 1.150-2(d)(2).
[51] I.R.C. § 54(e)(2).
[52] I.R.S. Notice 2005-98.
[53] I.R.C. § 54(b)(3).
[54] I.R.S. Notice 2005-98.
[55] As discussed in Part I, Section F, the maximum term for CREBs will be published daily by the Bureau of Public Debt on its Internet site for State and Local Government Series securities at http://www.publicdebt.treas.gov, which also lists the maximum permitted maturity for QZABs. Given that the methodology for calculating the maximum term of an issue of CREBs is the same as that for an issue of QZABs, it is likely that the published maximum maturity will be rounded to the nearest year, as it is for QZABs.

CREB Bond Maturity Calculation

Example

Adjusted AFR (100%/110%)	5.000%	5.500%
Loan Amount (100%/50%)	20,000,000	10,000,000

Semi-Annual Period	Hypothetical Loan Balance	Future Value @ 110% AFR
0.000	10,000,000.00	10,275,000.00
1.000	10,275,000.00	10,557,562.50
2.000	10,557,562.50	10,847,895.47
3.000	10,847,895.47	11,146,212.59
4.000	11,146,212.59	11,452,733.44
5.000	11,452,733.44	11,767,683.61
6.000	11,767,683.61	12,091,294.91
7.000	12,091,294.91	12,423,805.52
8.000	12,423,805.52	12,765,460.17
9.000	12,765,460.17	13,116,510.33
10.000	13,116,510.33	13,477,214.36
11.000	13,477,214.36	13,847,837.75
12.000	13,847,837.75	14,228,653.29
13.000	14,228,653.29	14,619,941.26
14.000	14,619,941.26	15,021,989.64
15.000	15,021,989.64	15,435,094.36
16.000	15,435,094.36	15,859,559.45
17.000	15,859,559.45	16,295,697.34
18.000	16,295,697.34	16,743,829.01
19.000	16,743,829.01	17,204,284.31
20.000	17,204,284.31	17,677,402.13
21.000	17,677,402.13	18,163,530.69
22.000	18,163,530.69	18,663,027.78
23.000	18,663,027.78	19,176,261.05
24.000	19,176,261.05	19,703,608.23
25.000	19,703,608.23	20,000,000.00
25.550	**20,000,000.00**	

Max Periods	**25.550**
Max Maturity (yrs.)	**12.775**

Pursuant to the Code, CREBs must provide for an equal amount of principal to be paid by the qualified issuer during each calendar year that the issue is outstanding.[56] A single bullet maturity is not permitted. Unfortunately, this will often require that issuers repay a portion of the principal prior to the placed in service date of the project. For instance, in the above example, the issuer must repay $1,565,558 ($20,000,000/12.775 years) during each calendar year that the bonds are outstanding.

This early amortization requirement will often mean that a qualified project originally financed by CREBs will need to be secured by general or system revenues. One potential means by which to have the CREBs secured by project revenues would be to have the qualified issuer/borrower originally finance a qualified project with the proceeds of another obligation (e.g., a line of credit or a tax-exempt bond), and subsequently issue CREBs to retire the external debt once the project is placed in service and generating revenue. This technique is permitted provided that indebtedness being

[56] I.R.C. § 54(l)(6).

refinanced by the CREBs was originally incurred by the qualified borrower after August 8, 2005, the effective date of the Act.

G. Issuer Reporting Requirement. Issuers of CREBs are required to file information reports similar to those filed pursuant to Section 149(e) (i.e., IRS Forms 8038 and 8038-G).[57]

H. Arbitrage Requirements. A bond shall not be treated as a CREB unless, with respect to the issue of which the bond is a part, the qualified issuer satisfies the arbitrage requirements of Section 148 of the Code.[58] Forthcoming Treasury Regulations are expected to clarify that:

1. 5-Year Temporary Period. If the qualified issuer reasonable expects to meet the 5-year spend-down requirement set forth in Part I, Section D (including the requirement that the issuer reasonably expects to incur within the 6-month period beginning on the date of issuance a binding commitment with a third party to spend at least 10% of the proceeds of such issue), then the proceeds of the issue qualify for a "temporary period" of 5 years beginning on the date of issuance, and any unspent proceeds after the end of such 5-year period are eligible for yield reduction payments.[59] The temporary period rules are a convention borrowed from the tax regulations applicable to tax-exempt bonds. Pursuant to a temporary period, CREB proceeds may be invested at an unrestricted yield. This is a helpful rule given that the yield on an issue of CREBs for investment purposes is determined based on the cost of funds to the qualified issuer which may be 0% (assuming each CREB maturity is sold at or above par) and not the tax credit rate paid to the bondholder.

2. Exception to Definition of Investment Property Does Not Apply. The Section 148(b)(3) exception to the definition of "investment property" for certain tax-exempt bonds shall not apply to CREBs.[60] Absent this provision, CREB proceeds could be invested in non-AMT municipal bonds and any earnings on such amounts would be excepted from arbitrage rebate.

3. CREBs Not Treated as Private Activity Bonds for Purposes of Rebate Exception for Bona Fide Debt Service Fund. CREBs shall not be treated as private activity bonds for purposes of the rebate exception applicable to amounts held in a bona fide debt service fund.[61] Under this provision, investment earnings on amounts held in a bona fide debt service fund (a convention borrowed from the tax regulations applicable to tax-exempt bonds) to pay annual principal on CREBs are not subject to the rebate requirement.

4. 2-Year Rebate Exception to Apply. The 2-year rebate exception applicable to tax-exempt bonds issued to finance construction expenditures shall apply to the available construction proceeds of an issue of CREBs.[62]

5. Small Issuer Rebate Exception Not to Apply. The small issuer rebate exception shall not apply. Under the small issuer rebate exception, investment proceeds of a bond issue in which $5 million or less of bonds are issued by an issuer during a calendar year are not subject to the rebate rules.[63]

I. CREBs Held By Partnerships, S Corporations and Other Pass-Thru Entities. Under forthcoming Treasury Regulations, in the case of an individual who owns an interest in an

[57] I.R.C. § 54(l)(7).
[58] I.R.C. § 54(i).
[59] I.R.S. Notice 2005-98.
[60] Id.
[61] Id.
[62] Id.
[63] Id.

unincorporated trade or business, is a partner in a partnership, is a beneficiary of an estate or trust, or is a shareholder in an S-corporation, the amount of the credit for any tax year shall not exceed an amount (separately computed with respect to such person's interest in such trade or business or entity) equal to the amount of tax attributable to that portion of a person's taxable income which is allocable or apportionable to the person's interest in such trade or business entity.[64]

J. CREBs Held By Regulated Investment Companies (RICs). The Act provides that, in the event a CREB is held by a regulated investment company, the tax credit allocable to such ownership shall be allowed to shareholders of such company under forthcoming procedures prescribed by the Secretary of the Treasury.[65]

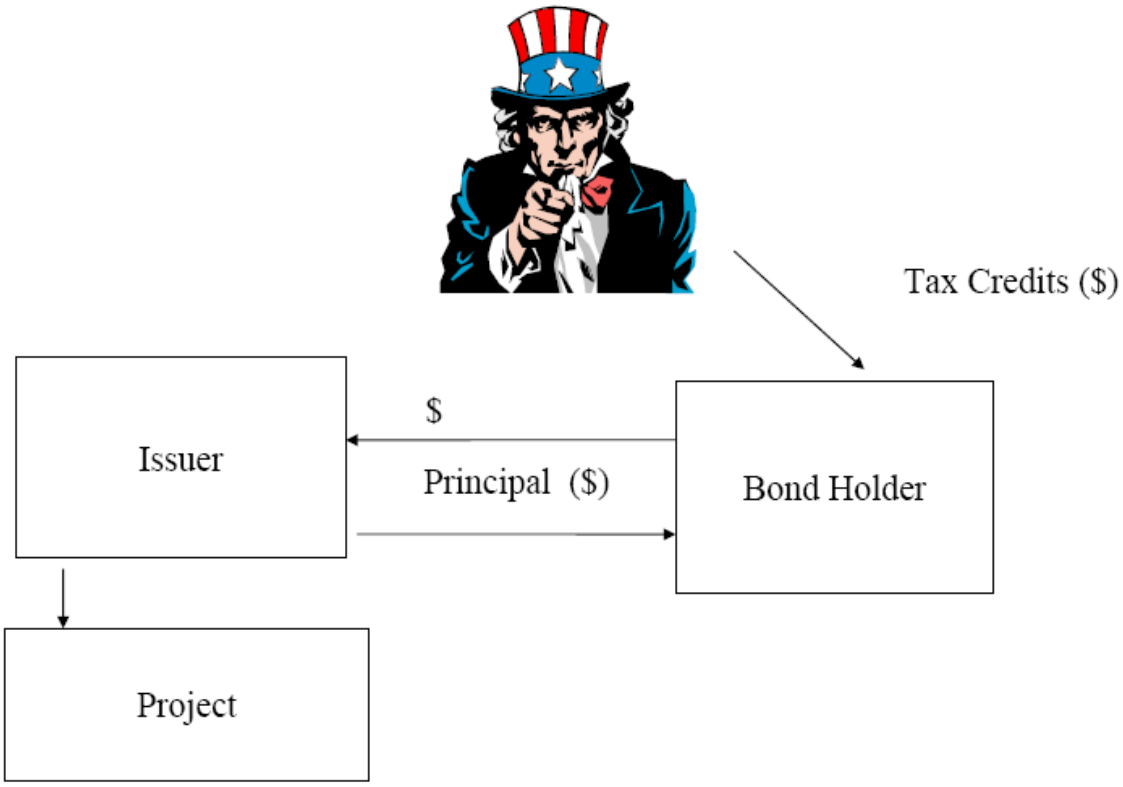
K. Estimated Taxes. For estimated tax purposes for both individuals and corporations, the credit arising from a CREB on a credit allowance date, determined without regard to any limitation on the amount set forth in Section 54(c), shall be treated as if it were a payment of estimated tax made by the taxpayer on such date.[66]

L. Interest Reporting. Tax credits received as a result of holding CREBs are subject to the interest reporting requirements of Section 6049.[67]

M. Sunset Provision. CREBs may not be issued after December 31, 2007.[68]

[64] I.R.C. § 54(l)(3), 41(g).
[65] I.R.C. § 54(l)(4).
[66] I.R.C. § 54(l)(5). It is worth noting that there is a mismatch between credit allowance dates for CREBs and the date that individuals are responsible for paying estimated taxes pursuant to Section 6654. As discussed in Part II, the credit allowance dates for CREBs are March 15, June 15, September 15 and December 15. Pursuant to Section 6654(c), the installment dates for individuals paying estimated taxes are April 15, June 15, September 15 and January 15.
[67] I.R.C. § 6049(d)(8).
[68] I.R.C. § 54(m).

II. Tax Benefits for Holders of CREBs.



Unlike QZABs, CREBs may be purchased and held by any taxpayer.[69] If a taxpayer holds a CREB on one or more credit allowance dates during any taxable year, the holder shall be allowed a tax credit in that tax year.[70] The amount of the credit with respect to any credit allowance date is equal to 25% of the annual credit, which is the product of the credit rate determined by the Secretary of the Treasury for the date on which the bond was sold, multiplied by the par amount of the bond.[71] "Credit allowance date" for these purposes is defined as March 15, June 15, September 15 and December 15, and also includes the last day on which a CREB is outstanding.[72] The Secretary of the Treasury shall determine daily a credit rate, which shall apply to the first day on which there is a binding, written contract for the sale or exchange of the bond.[73] The credit rate for any day is the credit rate which the Secretary of the Treasury or his or her designee estimates will permit the issuance of CREBs with a specified maturity or redemption date at par.[74] This rate will be determined using the estimate of the

[69] QZABs may only be held by banks, insurance companies and corporations actively engaged in the business of lending money. I.R.C. § 1397E(d)(6).
[70] I.R.C. § 54(a).
[71] I.R.C. § 54(b).
[72] I.R.C. § 54(b)(4).
[73] I.R.C. § 54(b)(3). The credit rate is the applicable clean renewable energy bond credit rate published each business day by the Bureau of Public Debt on its Internet site for State and Local Government Series securities at: http://www.publicdebt.treas.gov.
[74] Id. In the case of a CREB issued during the 3-month period ending on a credit allowance date, the amount of the credit shall be a ratable portion of the credit otherwise determined based on a portion of the 3-month period during which the CREB is outstanding. A similar rule applies when the CREB is redeemed or matures.

yield on outstanding AA-rated corporate bonds of a similar maturity for the business day immediately prior to the date on which the issue is sold.[75] The amount of any credit received under Section 54 shall be included in gross income of the taxpayer, and shall be treated as interest income.[76]

Example – Net Tax Benefit. Assume a bondholder in the 33% tax bracket receives a CREB tax credit in the amount of $1,000. The bondholder has taxable income in the amount of $1,000, resulting in a tax liability of $330 (33% x $1,000). The net tax benefit, therefore, is a tax credit in the amount of $670 ($1,000 - $330).

Example – Tax Credit Calculation. Assume the credit rate for an issue of CREBs sold on July 1, 2006 is 6%. Further assume that, on June 15, 2009, the principal outstanding amount of the issue is $14,000,000. On June 15, 2009, the taxpayer will receive a tax credit in the amount of $210,000, which is 25% of the tax credit rate of 6%, multiplied by the principal amount of the outstanding bonds of $14,000,000.

Note that, as principal is paid annually on an issue of CREBs as required by the statute, the amount of the tax credit (and interest deemed received by the holder of the CREB) will decrease.

The holder of a CREB treats the bond as if it pays interest on the credit allowance date.[77] In the event a CREB is sold between credit allowance dates, part of the sales price of the CREB received by the seller represents interest accrued to the date of the sale and must be reported as interest income.[78] For the purchaser of a CREB who purchases between credit allowance dates, any interest which is in arrears but has accrued at the time of purchase is not income and is not taxable as interest if subsequently paid.[79] Such payments are deemed returns of capital, which reduce the purchaser's basis in the CREB.[80] A literal reading of the Act suggests that a purchaser of a CREB who acquires the CREB prior to a credit allowance date receives the full benefit of the tax credit, i.e., the entire credit "springs" to the taxpayer on the credit allowance date.[81]

Assume, for example, that a taxpayer purchases a CREB on March 13th. For the period between March 13th and March 15th, the purchaser will have income in the form of interest accrued between March 13th and 15th, but will receive the full value of the tax credit on March 15th.[82] For the seller, a portion of the sales price of the CREB will be deemed to be interest accrued to the sale date, and must be reported as income. In addition, the seller would not receive any portion of the tax credit for the period between December 15th and March 15th.

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[75] I.R.S. Notice 2005-98.
[76] I.R.C. § 54(g).
[77] Borrowing from concepts provided in the QZAB regulations, the interest paid on CREBs should be treated as qualified stated interest. See Treas. Reg. § 1.1397E-1(f). Also, Section 6049(d)(8)(A) (regarding the reporting of interest), which provides that CREB interest shall be treated as paid on the credit allowance date.
[78] Treas. Reg. 1.61-7(d).
[79] Treas. Reg. 1.61-7(c).
[80] Id.
[81] Although a literal reading of Section 54(a) would seem to indicate that the credit does not accrue, but rather "springs" into fruition on a credit allowance date, the Conference Report for the Act provides that "[t]he credit accrues quarterly and is includable in gross income..." H.R. Conf. Rep. 109-190.
[82] Interest in arrears that has accrued prior to March 13th will be deemed a return of the purchaser's capital, and will reduce the purchaser's basis in the CREB.

The CREB tax credit is not refundable, and may not be carried forward or backward into other tax years. Thus, the holder of a CREB tax credit is in a "use or lose" position with respect to the tax credit in the year in which it arises. The amount of the tax credit allowed for any taxable year shall not exceed the sum of a taxpayer's regular tax liability (as defined in Section 26(b)) plus the alternative minimum tax (as provided in Section 55), less the sum of other credits allowed under Part IV, Subchapter A of Chapter 1 of the Code (other than certain refundable credits set forth in Subpart C of Part IV).[83]

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[83] I.R.C. § 54(c).